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No. 88-1003

In The

Supreme Court of the United States

October Term, 1988

COLONIAL SAVINGS ASSOCIATION and SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF OF PETITIONERS

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ARGUMENT

I. The Commissioner's argument that this Court should not take into account the pendency of the *Centennial* appeal ignores the potential economic impact of such a step on financial institutions in the Seventh Circuit.

In their Petition, the Petitioners noted (Pet. p. 8) that the decision of the Court of Appeals in this case is directly contrary to the decision reached by Acting Chief Judge Sanders in *Centennial Savings Bank FSB v. United States*, 682 F. Supp. 1389 (N.D. Tex. 1988), and that the latter

decision is now on appeal by the Government to the Court of Appeals for the Fifth Circuit (Appeal No. 88-1297). The Petitioners therefore suggested that this Court should defer any decision with respect to the instant Petition until the Fifth Circuit has decided the *Centennial* appeal; then, if the Fifth Circuit upholds the District Court, there will be a direct conflict between the two Circuits which this Court might well decide to resolve.

The Commissioner responds that there is "no merit" to this suggestion because "[t]here is no reason to anticipate" that the Fifth Circuit will affirm the District Court in *Centennial* and that, if it does, this Court can then consider whether certiorari is appropriate in that other proceeding. (Brief in Opposition, p. 4).

The Commissioner's response to Petitioner's suggestion is inappropriate and disappointing. As the Commissioner well knows, his "solution" to the problem has as its only advantage the potentiality of generating significant unjustified tax revenues for the Treasury. If the Commissioner's "solution" were adopted, a significant possibility would arise that savings institutions located in states comprising the Seventh Circuit would be forced to bear a substantial tax burden for past years not shared by institutions located in other jurisdictions.[1] Conversely, if this Court were to accept the Petitioner's suggestion and defer action on the instant Petition until the Fifth Court has had an opportunity to decide *Centennial*, this Court (without increasing its own burden in any respect whatsoever) could then act with assurance that the ultimate resolution of this highly important issue will apply nationwide. This Court can surely take judicial notice of the troubled state of the savings industry and Petitioners respectfully sug-

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[1] This would occur if (i) the instant Petition were denied, (ii) the Fifth Circuit affirmed the District Court's decision in *Centennial* and (iii) that affirmance was either not appealed by the Government or was appealed and upheld by this Court.

gest that this Court, merely by deferring consideration of the instant Petition for a short additional period, can avoid introducing another substantial destablizing factor into an already unstable industry.

II. The Commissioner has failed to distinguish *Columbia Gas System* from the instant case.

The petitioners have also pointed out (Pet. p. 13) that the decision of the Court of Appeals in the instant case is in direct conflict with the decision of the Second Circuit Court of Apeals in *Columbia Gas System, Inc. v. United States*, 473 F.2d 1244 (2d Cir. 1973). The Commissioner attempts to minimize this conflict by distinguishing *Columbia Gas System* on its facts (Brief in Opposition, p. 7) but, although the two cases involve different industries, they present the same precise issue.

In *Columbia Gas System*, the taxpayer had issued debentures with a fixed interest rate and maturity date; the debentures could be converted into stock of the issuer at the election of the debenture holder but, in the event of such a conversion prior to the debenture maturity date, the holder would be required to forfeit a portion of the interest due to it under the terms of the instrument. The Second Circuit held that the income generated to the issuer as a consequence of the interest forfeiture was income arising "by reason of the discharge . . . of indebtedness" under I.R.C. §108, which income could have been deferred if the taxpayer had made a timely election to do so. As can be seen, this result is in direct conflict with the holding of the Court of Appeals in the instant case and, on that basis alone, this Court should accept the instant Petition.

The Commissioner, however, attempts to distinguish *Columbia Gas System* with the following analysis (quoted in its entirety):

> "In *Columbia Gas*, some of the taxpayer's convertible bonds were converted into stock and the

> penalty for that conversion under the terms of the bonds was forfeiting the accrued interest on the bonds. The bondholders had no separate obligation to the taxpayer and did not receive anything in exchange for the discharged interest debt."

Brief in Opposition, p. 7. These statements may be true[2] but they apply as well to the transactions at issue in the instant case. Thus, just as there was in *Columbia Gas System* a so-called "penalty" for converting a debenture prior to its maturity, there was in the instant case a so-called "penalty" for prematurely withdrawing a savings account. And just as this "penalty" in *Columbia Gas System* was to be statisfied by "forfeiting the accrued interest on the bond," the "penalty" in the instant case was to be satisfied by a forfeiture of accrued interest on the account. Finally, just as there were no "separate obligations" owed by the debenture holders to the taxpayer in *Columbia Gas System* (since the so-called "penalty" arose out of and only because of the premature conversion), there was for the same reason no "separate obligation " owed by an account holder to the taxpayer in the instant case.[3] In

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[2] It is, though, impossible to understand the meaning of Commissioner's contention that in *Columbia Gas System*, the debenture holders "did not receive anything in exchange for the discharged interest debt." The benefit received by the holders was the right to convert their bonds prior to maturity or, in other words, to change their investment into an instrument with a greater potential return. Obviously, this was the economic benefit that motivated their decision to accept the "penalty" of forfeiting the interest otherwise due to them. In the instant case, of course, the account holders acted with precisely the same motivation and accepted the same penalty therefor.

[3] The Commissioner (Brief in Opposition, p. 7) mistates Petitioner's argument (that there was no "separate obligation" between the taxpayer and its depositiors) as resting on the sole fact that there was only one "contract" between them. This, however, is only one relevant factor. More significant is the fact that the so-called "separate obligation" (that is, the penalty)

(Footnote continued on the following page)

short, the Seventh Circuit in this case and the Second Circuit in *Columbia Gas System*, faced with the same issue, reached opposite results and the Commissioner has failed to demonstrate any relevant distinction between the two cases.

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3 *(Continued)*
arose only in, and because of, the very transaction in which the debt forgiveness occurred; in all the other "separate obligation" cases cited by the Commissioner, the obligation owed by the debt holder to the taxpayer arose in an entirely separate transaction between the parties and, if it had not been satisfied by the debt forfeiture, it would have had to be paid in some other manner.

CONCLUSION

For the reasons stated herein and in the initial Petition, this Court is again respectfully requested to (i) delay taking any action with respect to this Petition until the Fifth Circuit Court of Appeals has decided the *Centennial* case and (ii) in any event, grant this Petition.

Respectfully submitted,

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